MARTIN INVESTMENT MANAGEMENT, LLC
1560 SHERMAN AVENUE SUITE 1250
EVANSTON, ILLINOIS 60201

(847) 424-9124
FAX (847) 424-9182

July 2023

The Unsustainability of the Present

In the second quarter of 2023, the S&P 500 Index had a total return of 8.74% and 16.89% for the half year. For the same period, the MSCI EAFE Index (USD) Net had a total return of 2.9% and 11.67% for the half year while the MSCI World Index (USD) Net had a total return of 6.83% for the second quarter and 15.09% for the first six months. Since the beginnings of the COVID pandemic, investors have experienced several unwelcomed geopolitical, financial, and economic upheavals on a global front, which have all increased market volatility. Time is necessary for the significance of these surprises to be fully absorbed. Many present transitory but recurring dynamics are leading to permanent secular changes worldwide. Additionally, as the global economies of the developed world exit a period of massive fiscal and monetary mediations as well as supply chain disruptions, the surge in inflation has not been easily contained. While the unconventional policies provided some temporary benefit for the developed world economies, they also are resulting in long-term costs, particularly the increase in sizable sovereign debt levels, which may mean less capacity to address future downturns. As the support for the economy and market reverses, the consequence is contributing to slower global growth and differentiated returns across investments.[1]

The subjects of consensus macroeconomic views in 2023 have ranged from no recession, to a mild recession to a financial crisis and back again. Forecasting economic shifts in the future is difficult. Because economies are increasingly moving to local rhythms, it is getting more difficult for investors to grasp the global economy. The global divergence has already swung currencies.[2] In June of 2023, three of the biggest central banks came to starkly different conclusions about their economies with the eurozone raising rates, the U.S. on hold, and China cutting rates. Europe is in a technical recession, but the European Central Bank (ECB) expects inflation to last. The U.S. economy is doing surprisingly well, and inflation has plunged, but underlying increases in service prices remain stubbornly high. China's data does not indicate a robust reopening in 2023 as China's recovery falters, and its real estate continues to weaken. Other central banks made different choices. The Bank of England (BoE) shocked the markets with a 50 bps rate hike to 5% as a 25 bps was expected. Hotter than expected inflation of 8.7% year over year in May 2023 forced the BoE to hike rates despite the lingering growth worries. The Swiss National Bank (SNB) hiked it policy rate 25 bps to 1.75% as expected. The Norges Bank hiked its policy rate 50 bps to 3.75%, while 25 bps was expected. Japan has remained the odd G7 country, remaining rate neutral.[3]

Because higher interest rates and tightened money supply have consequences, a recession or slowdown is still possible in the next 12 months. Monetary policy has already negatively impacted property prices, bank solvency, lending conditions, defaults, and corporate profits. The final effect of tight monetary policy is typically seen in increasing unemployment, which may have just begun to have an effect.[4] Absent a stunning increase in worker productivity, the shortage of qualified workers is holding back economic growth. If open positions were filled, output (GDP) and income would definitely expand. Virtually all industry classifications show significant numbers of firms unable to hire the workers they need. Additionally, according to the Labor Department this was the fifth straight quarter of negative year-over-year productivity growth, the longest such run since records began in 1948.[5] Finding solutions to the problems of labor supply will take time, holding back the rate of growth of the economy. Economies have gone through periods where output has expanded faster than employment but not the other way around.[6]

As the economies are likely downshifting, investors may want to take heed. We believe that the developed world economies are likely now headed for a period of below-trend growth, as "sticky" inflation detracts from real activity and as policy (both fiscal and monetary) re-orients. The combination of persistently elevated inflation, higher interest rates, and stringent credit conditions will constrain private sector spending power. Already interest rate sensitive sectors of housing and banking have experienced a significant amount of stress. While a generally healthy consumer and corporate balance sheets have provided some cushion for now, the risks from nonlinear spending and investment decisions should not be underestimated. Ernst and Young believes that a modest recession in the second half of 2023 will occur with low but positive GDP growth.[7] There is some evidence that core goods are returning to normal, and that wages and core services are just beginning to be adjusted downward. As the macro environment may experience a shift in the coming months, consumers may retrench, and businesses may begin to slow hiring.[8]

Investors face a difficult quandary, balancing poor economic data on one level and equity markets that appear to be looking through nearly every negative indicator on the other. The markets have been resilient despite the economic headwinds. Sentiment is no longer pessimistic, and growth is still holding up but at a slower pace with fewer upward surprises.[9] The market's strong advance off the October 22, 2022 low has been a welcomed sign. Because the central banks have taken their inflation seriously by hiking rates, government bonds are regaining long-term yield stability. While the central banks' aggressive hikes have pushed up front-end yields, long-term bonds have been stable, not due to recession fears but the comfort that policymakers are serious about bringing inflation down.[10] The stock market bulls are growing in numbers despite the negativity on the economy. The bears have been correct about the economy but not the market. Investors are experiencing "a frustrating dichotomy" between a more bullish market and bearish economy.[11]

Market breadth is important. The recent rally on a narrow breadth of technology stocks had been holding the index in positive territory in 2023, but recently the markets have been broadening with positive returns for 11 Sectors this quarter. The old TINA (There Is No Alternative) of chasing stocks due to zero interest rates is now the new performance chasing FOMO (The Fear of Missing Out). Capital investment in artificial intelligence (AI) has soared from approximately $14 billion ten years ago to $276 billion in 2021.[12] The U.S. is responsible for 54% of this capital spending, followed by China at 15%. AI is so strong that without the AI-popular stocks, the S&P would be down 2% this quarter, not up over 8%. Approximately, for each $1 invested in the S&P 500 Index, $0.32 flows directly into ten stocks. The remaining $0.68 is divided between the remaining 490 stocks. The "Generative AI" innovation is powerful, and investors are participating in this market, but they should be aware that expectations can exceed fundamental realities.[13]

Martin Investments Management, LLC believes that the growth trajectory of a few technology stocks, trading at recent lofty levels, because of their AI production and corresponding free cash flow, only tell part of the story. About a quarter of the S&P 500 Index companies referred to their initiatives into AI for their Q1 2023 earnings calls so artificial intelligence is more pervasive than a few technology companies and represents a longer term trend. Nonetheless, a few large technological companies have been the biggest beneficiaries of 2023's AI investing. Jason Trennert of Strategas Partners states wisely, "Valuation might not matter in this initial phase of artificial intelligence-it is 'new' and has the potential to revolutionize business. Whether this turns out to be hype or the real thing, it will likely be some time before we learn who the real winners from AI will be."[14]

Recent earnings results have led some analysts to expect an earnings reacceleration in the second half of 2023, particularly in sectors that are able to put upward pressure on inflation, offer new innovations, or supply a current consumer demand. The reacceleration for the rest of 2023 could not occur if a recession does materialize. Given the fundamental view on growth, Martin Investment Management, LLC believes the current market excitement may be short lived as a painful adjustment may occur for investors who disregard the lagged impact of policy tightening. Earnings are backward looking and the impact of tightening monetary policy takes time to manifest.[15] More importantly, recessions, bull and bear markets are only identified in hindsight. Market risk has also increased materially based on the valuation of the market with the S&P 500 Index presently trading less than 10% below its 2022 peak.[16]

Martin Investment Management, LLC believes that the upheavals, caused from the COVID pandemic and its aftermath, have been as equally damaging to fragile economies as inaction. With the ongoing adjustment period following the COVID pandemic, we aim to have a balance between resilient, more liquid equities and timely diverse growth opportunities. We seek to find these growth opportunities in businesses, who sell their product/services to a broad market. While equities are considered to have an outsized risk adjusted return, we believe risks can be mitigated by investing in a broad universe of fundamentally healthy public companies with profitable long-term return potential. We will continue to monitor changes in monetary and fiscal policies, equity risk premiums, company fundamentals, and relative valuations, which influence portfolio positioning. Martin Investment Management, LLC believes that by participating in diverse and active portfolios, investors have the potential to identify the companies, which have the power to achieve shareholder return with efficient and profitable use of capital.

Wishing you an enjoyable summer season!

---

1. Clarida, Richard, Daniel Ivascyn and Andrew Balls. “The Aftershock Economy”, *Advisor Perspectives*, June 9, 2023.
2. Mackintosh, James. “Global Economy Looks Out of Sync”, *Wall Street Journal*, June 17, 2023.
3. Lees, Andrew. “Morning Headlines”, *MacroStrategy*, June 23, 2023.
4. Evans, Gary. “Navigating The Recession”, *BCA Research*, June 2023.
5. Guilford, Gwynn. “Productivity Drop Blurs Economic Picture”, *Wall Street Journal* June 5, 2023.
6. Guilford, Gwynn. “Productivity Drop Blurs Economic Picture”, *Wall Street Journal* June 5, 2023.
7. Daco, Gregory. “A ‘Janusian’ US economy”, *EY Parthenon Insights*, May 25, 2023.
8. Gillum, Lawrence and Roach, Jeffry. “Market Responses to Fed (In) Action”, *Advisor Perspectives*, June 20, 2023.
9. Evans, Gary. “Navigating The Recession”, *BCA Research*, June 2023.
10. Reynolds, Garfield and Carson, Ruth. “Traders Can’t Get Enough of Treasuries Even with Hawkish Fed”, *Advisor Perspectives*, June 23, 2023.
11. Bohnsack, Nicholas. “Upgrading Technology to Neutral”, *Strategas Asset Allocation*, June 23, 2023.
12. Huebscher, Robert. “Jeremy Siegel-The Market is Not in a Bubble”, *Advisor Perspectives*, June 23, 2023.
13. Roberts, Lance. “A.E., Narrow Markets, And the New T.I.N.A.”, *Advisor Perspectives*, May 31, 2023.
14. Trennert, Jason. Grabinski, Ryan. “Institutional Ownership & A.I. Stocks”, *Strategas Investment Strategy Report*, June 15, 2023.
15. Guggenheim. “Research Spotlight on What Is Next”, Second Quarter 2023, June 2023.
16. Hussman, John. “Grasping at the Suds of Yesterday’s Bubble”, *Advisor Perspectives*, June 21, 2023.